DEPARTMENT OF STATE REVENUE

04-20110292.LOF

Letter of Findings: 04-20110292
Sales and Use Tax
For the Years 2008 and 2009

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ISSUES

I. Sales and Use Tax – Imposition – Exemptions.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-4-13; 45 IAC 2.2-5-8; 45 IAC 2.2-5-12; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer protests the assessment of sales/use tax on purchases of electricity.

II. Tax Administration – Interest.

Authority: IC § 6-8.1-10-1.

Taxpayer protests the imposition of interest.

III. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana company which manufactures asphalt to be used in the construction of roads, parking lots, and driveways. The Indiana Department of Revenue ("Department") conducted a sales/use tax audit for tax years 2008 and 2009. Pursuant to the audit, the Department determined that Taxpayer did not pay sales tax on certain purchases of tangible personal property, including electricity. Even though Taxpayer did not have a valid utility study, the Department's audit estimated that Taxpayer directly used five (5) percent of the electricity it purchased for those years in its manufacturing process because Taxpayer did not separately meter for its use of the electricity for its manufacturing process. The audit thus determined that 95 percent of Taxpayer's purchases of electricity were subject to sales/use tax. As a result, the Department's audit assessed use tax on the grounds that Taxpayer did not pay sales tax or self-assess and remit the use tax on certain purchases of tangible personal property, which Taxpayer used for its business, including 95 percent of electricity.

Taxpayer paid the assessment. In addition to penalty and statutory interest, Taxpayer protested the assessment on its purchases of electricity only. Taxpayer submitted its own utility study on its use of the electricity. Taxpayer stated that it did not have any production in January and February due to the cold weather. Thus, Taxpayer's utility study used 44 weeks a year to calculate the average hours per week for its electricity consumption for each of its machines used in production. As a result, Taxpayer's utility study utilized an average of nine (9) hours per week for the majority of its machinery used in the manufacturing process, including two conveyors (the main conveyor and the recycle conveyor). Additionally, Taxpayer's utility study utilized an average of 50 hours per week for its use of the air compressors. Referring to its utility study, Taxpayer stated that, based on its calculation, it directly used 62 percent of the electricity it purchased in its manufacturing process and that it was entitled to a 100 percent exemption for its predominant use.

Prior to the administrative hearing, the Department's auditor reviewed Taxpayer's utility study and determined that Taxpayer used 41 to 42 percent of the electricity in its manufacturing process, and, thus, allowed Taxpayer a partial exemption based on the actual usage of the electricity. Taxpayer disagreed and continued its protest on its purchases of electricity, claiming that it was entitled to the "predominant use" exemption. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition – Exemptions.

DISCUSSION

Upon reviewing Taxpayer's utility study, the Department's audit determined that Taxpayer consumed approximately 41 to 42 percent of the electricity it purchased in its manufacturing process, and thus, allowed Taxpayer a partial exemption based on the actual percentage pursuant to IC§ 6-2.5-5-5.1 and 45 IAC 2.2-5-12. Taxpayer, to the contrary, asserted that based on its own calculation, it was entitled to the "predominant use" exemption on all of its electricity pursuant to 45 IAC 2.2-4-13.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in

Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Id. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. 45 IAC 2.2-5-8(a). Tangible personal property means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses. IC § 6-2.5-1-27. Tangible personal property also includes electricity, water, gas, steam, and prewritten computer software. Id.

An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Id. at 100-101.

IC § 6-2.5-5-5.1 provides:

(a) As used in this section, "tangible personal property" includes **electrical energy**, natural or artificial gas, water, steam, and steam heat.

(b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for **direct consumption as a material to be consumed in the direct production** of other tangible personal property **in the person's business of manufacturing**, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

(c) A refund claim based on the exemption provided by this section for electrical energy, natural or artificial gas, water, steam, and steam heat may not cover transactions that occur more than eighteen (18) months before the date of the refund claim. (**Emphasis added**).

45 IAC 2.2-5-12 explains:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) Pre-production and post-production activities.

(1) Direct consumption in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required.

(2) "Direct use in mining" begins with the drilling of the shaft or well or the first removal of overburden in surface mining or quarrying. It ends when the item being mined or extracted has been physically removed from the mine, well, or quarry.

(e) "Have an immediate effect upon the article being produced or mined." Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these

regulations [45 IAC 2.2].

(f) Other taxable transactions. Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B above [subsection (e) of this section] are taxable. Such activities include post-production activities; storage step) [sic]; maintenance, testing and inspection (except where in direct production); (except where essential and integral to the process system); management and administration; sales; research and development; exhibition of products; safety or fire prevention; space heating; ventilation and cooling equipment for general temperature control; illumination; shipping and loading.

(g) "Consumed" as used in this regulation [45 IAC 2.2] means the dissipation or expenditure by combustion, use, or application and does not mean or include the obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, dies, equipment, machinery, or furnishings.

45 IAC 2.2-4-13, in relevant part, explains:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to tax.

...

(c) **Sales of public utility services or commodities to consumers engaged in manufacturing**, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted **if such services are separately metered or billed and will be used predominantly for the excepted purposes**.

(d) **Sales of public utility services and commodities to consumers engaged in manufacturing**, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, **based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes**.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, **the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes**. **Predominant use shall mean that more than fifty percent (50 [percent]) of the utility services and commodities are consumed for excepted uses**. (**Emphasis added**).

In this instance, after the audit was concluded, Taxpayer conducted its own utility study. Taxpayer's original utility study utilized an average of nine (9) hours per week (based on its own estimate) for the majority of its machinery used in the manufacturing process, including the main conveyor and the recycle conveyor. Additionally, Taxpayer's utility study utilized an average of 50 hours per week for its air compressors.

The Department's audit reviewed the utility study and determined that Taxpayer should be allowed an average 9 hours per week for its use of the air compressors. The Department's audit also estimated that Taxpayer only used 25 percent of the main conveyor and 40 percent of the recycle conveyor in its manufacturing process; Taxpayer's manufacturing process started after the raw materials were weighed by scales, which divided the use of the conveyors into pre-production and production portions. Based on those two adjustments, the Department's audit concluded that Taxpayer consumed 41 to 42 percent of the electricity it purchased in the manufacturing process and, thus, was qualified for a partial exemption.

At the administrative hearing, Taxpayer reiterated that its utility study showed that it consumed more than 50 percent of the electricity it purchased in its manufacturing process. Thus, it believed that it was entitled to the "predominant use" exemption on its purchases of the electricity. Specifically, Taxpayer presented two revised utility studies showing that it utilized an average 12-hour per week and an average 15-hour per week (based on the 44-week a year) to arrive at its conclusions that Taxpayer predominantly used the electricity in its manufacturing process. Taxpayer stated that, although, in its original utility study, it only used an average 9-hour per week for the majority of its machinery, it estimated the average hours should be increased to between 12 hours and 15 hours per week. Second, Taxpayer claimed that the auditor estimated only 25 percent of the main conveyor and 40 percent of the recycle conveyor used in the manufacturing process; to the contrary, it used at least 60 percent of each of the conveyors in its manufacturing production.

Subsequently after the hearing, Taxpayer provided the actual measurements of both conveyors concerning pre-production portion. From there, Taxpayer calculated the actual portion of the conveyors used in its manufacturing process in computing the actual percentage of the exempt use – 59.15 percent and 58.67 percent. Thus, rather than relying on the estimates, pending a supplemental audit's verification, the Department will allow the exempt use at 59.15 percent for the main conveyor and 58.67 percent for the recycle conveyor.

Additionally, after the hearing, Taxpayer claimed that its machinery only operated 42 weeks (not 44 weeks), which, increased the average hours per week in its revised utility studies as a result: namely, 16.6 hours per week for 2008 and 12.36 hours per week for 2009. To support its claim, Taxpayer submitted a summary (calculating the total hours for those years), copies of the production logs, and its revised utility studies for those years. Upon reviewing Taxpayer's underlying documentation, however, its documentation reflected various inconsistencies

which cannot be verified. Throughout the protest process, Taxpayer revised its utility studies in multiple occasions, asserting changes of the factors in calculating its "predominant use" of the electricity. Taxpayer may, and rightly so, assert that its machinery was operated on an average of 9 hours, 12 hours, 15 hours, or even 16.6 hours; however, deciding which average hours per week for the utility study did not fall into the purview of a legal protest. The administrative hearing is not the proper forum to decide which version of Taxpayer's utility studies is more accurate and therefore more acceptable. Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden of proof demonstrating that it used its machinery more than 9 hours per week for its production.

In short, Taxpayer provided the actual exempt usage of the two conveyors, so the Department will allow 59.15 percent and 58.67 percent exemption for its use of the electricity for the two conveyors in a supplemental audit accordingly. However, the Department is not able to agree that Taxpayer met its burden of proof demonstrating that it used its machinery more than 9 hours per week for its production.

Upon verifying the total actual percentage of electricity used in Taxpayer's manufacturing process, the Department's supplemental audit will determine whether Taxpayer's use of its electricity for its manufacturing process exceeded 50 percent, and therefore, qualified for the "predominant use" exemption under 45 IAC 2.2-4-13. If Taxpayer's total percentage of electricity use in its production did not exceed 50 percent, the Department will allow a partial exemption based on Taxpayer's actual percentage used pursuant to IC § 6-2.5-5-5.1 and 45 IAC 2.2-5-12.

FINDING

Taxpayer's protest is sustained in part and respectfully denied in part. Taxpayer is sustained on its 59.15 percent and 58.67 percent use of the two conveyors. However, Taxpayer's protest is respectfully denied on its claim that it used its machinery more than 9 hours per week for its production.

Upon recalculation and verification in a supplemental audit, the Department will either apply the "predominant use" exemption under 45 IAC 2.2-4-13 or allow a partial exemption based on actual percentage used under IC § 6-2.5-5-5.1 and 45 IAC 2.2-5-12 accordingly.

II. Tax Administration – Interest.

DISCUSSION

The Department assessed interest on the tax liabilities. Taxpayer protests this imposition of interest.

IC § 6-8.1-10-1(a) provides, as follows:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

Pursuant to IC § 6-8.1-10-1(e), the Department does not have the authority to waive the interest. Therefore, Taxpayer's protest is denied.

FINDING

Taxpayer's protest to the imposition of interest is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;

(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

(4) fails to timely remit any tax held in trust for the state; or

(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause,

the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has demonstrated that the imposition of the negligence penalty is not appropriate.

FINDING

Taxpayer's protest is sustained.

SUMMARY

For the reasons discussed above, on Issue I, Taxpayer's protest is sustained in part and respectfully denied in part. Taxpayer is sustained on its 59.15 percent and 58.67 percent use of the two conveyors. However, Taxpayer's protest is respectfully denied on its claim that it used its machinery more than 9 hours per week for its production. Upon verification in a supplemental audit, the Department will either apply the "predominant use" exemption under 45 IAC 2.2-4-13 or allow a partial exemption based on actual percentage used under IC § 6-2.5-5-5.1 and 45 IAC 2.2-5-12 accordingly.

On Issue II, Taxpayer's protest to the imposition of interest is respectfully denied. On Issue III, Taxpayer's protest of the negligence penalty is sustained. Since Taxpayer paid the assessment prior to the protest, the Department will refund Taxpayer's overpayment accordingly.

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